



# **NAVAL POSTGRADUATE SCHOOL**

**MONTEREY, CALIFORNIA**

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## **MBA PROFESSIONAL REPORT**

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**An Analysis of Year-End Spending and the Feasibility of a Carryover  
Incentive for Federal Agencies**

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**By: Michael F. McPherson  
December 2007**

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**AN ANALYSIS OF YEAR-END SPENDING AND THE FEASIBILITY OF A  
CARRYOVER INCENTIVE FOR FEDERAL AGENCIES**

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Submitted in partial fulfillment of the requirements for the degree of

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This project investigates the year-end “rush to spend” and its origins. A secondary examination considers the feasibility of using carryover incentives to extend the obligation period by up to twelve months. Problems associated with the current one-year limitation are documented. Possible fixes for execution problems are presented, and one solution, the carryover incentive, is analyzed in depth. Findings include many examples at both the federal and state levels that suggest year-end spending leads to poor decisions and wasted resources. Despite a history of ineffective budgetary and policy changes the proposed carryover incentive has proven successful in the limited occasions that it has been adopted.

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Special thanks go to Pam Davidson at the State of Washington's Office of Financial Management, for offering assistance and important historical data.

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## **EXECUTIVE SUMMARY**

On four occasions in the past twenty-five years, the Government Accountability Office (GAO) was asked to investigate year-end spending and purported waste due to a “rush to spend” occasioned by the annual fiscal deadline. For organizations that use one-year operations and maintenance (O&M) funds, the thirtieth of September is the final day in which to obligate congressionally appropriated funds. At midnight on the first of October, unexecuted authority expires and may not be used except in special circumstances. Any leftover balances represent either lost opportunity for the agency or excessive budget authority having been granted. The Office of Management and Budget calculated unobligated balances from operations and maintenance accounts for the Department of Defense at \$1.744 billion in 2005 (OMB, 2007). Agencies surrendering authority for unobligated funds risk a second impact after the loss of the monies themselves: unneeded funds may trigger cuts to baseline funding in subsequent years. Agency executives have argued that one year is not long enough to properly execute authority—that the short obligation period constrains their ability to meet mission objectives, encumbering them with budgetary inflexibility, penalties for savings, damping of strategic planning, and the temptation to spend heavily at the end of the year. Others have argued, however, that one year is indeed enough time to execute a properly prepared spending plan, and no extra time is needed.

In May 2006, a hearing was held before the Congressional Homeland Security and Government Affairs Subcommittee on Federal Financial Management, Government Information, and International Security committee. The hearing, “Unobligated Balances: Freeing up Funds, Setting Priorities and Untying Agency Hands,” examined the billions of unspent dollars sitting in government carryover accounts and asked whether the money could be used to remedy budget deficits. Chairman Tom Coburn broached the issue of giving federal departments authority to carry over funds from one fiscal year to the next. The idea of carryover incentives is not new; the assumption that they would encourage entrepreneurialism in federal agencies and yield benefits such as efficiency and long-term

savings has been voiced before. Yet despite the popularity of the idea as a general notion, very little study of carryover-incentive plans has been made.

At the hearing cited above, the Department of the Treasury estimated that \$16.4 billion was returned to the treasury in 2005 from O&M accounts. Because every dollar the legislature appropriates has an intended purpose and desired outcome, this figure represents a staggering loss of opportunity in fulfilling the will of Congress and the people. Less tangible, because largely anecdotal, is the massive loss at year's end, when low priority and even flagrantly wasteful expenditures may be made to protect agencies' budgets.

Increasingly, budget theorists are supporting the extension of the O&M obligation period by up to one year, through the use of carryover incentives. The belief is that extra time for obligating funds will encourage more effective and efficient spending within the context of the annual budget, maximizing the value of each dollar as federal executives enjoy sufficient time to optimize expenditures. As confirmed by Lee L. Loftus, the Assistant AG, Controller of the Justice Department, concerning his own department, "Using expired funds helps prevent the zeal to spend down at the end of the year and provides a built in incentive to our program managers to have excellent stewardship over those funds because the agency can really put them to good use later" (Conlon, 2006, p. 1).

## **I. PROJECT OUTLINE**

### **A. PURPOSE**

The purpose of this research project is twofold: first, to determine if the current O&M obligation time restrictions create a significant likelihood of inefficiency and waste; and second, to determine if extension of the one-year appropriation period through the addition of a carryover incentive might improve mission accomplishment and generate savings.

### **B. RESEARCH OBJECTIVES**

The objective of this research is to analyze the one-year appropriation process and the resulting year-end spending phenomenon to determine if there is a significant chance of [decreasing?] year-end spending waste. The second objective is to analyze the proposal that the period of availability of O&M funds be extended through carryover incentives, to determine what gains might be reaped by this measure.

### **C. RESEARCH QUESTIONS**

The author found no available measurements or metrics for critiquing the quality of year-end spending or the impact that the one-year window has on agencies. While offering carryover incentives has been tried at the state and local levels and a variation has been tried in the Justice Department, a concerted and comprehensive attempt has not been made at the federal level.

This project asks whether the annual spending deadline represents significant potential for waste and whether extending the obligation period through carryover incentives will improve mission accomplishment and lead to significant savings.

### **D. METHODOLOGY**

Research was conducted via examination of historical documents, scholarly articles, case studies, and government reports and through personal interviews. All

persons interviewed were assured anonymity and therefore the project does not cite them specifically. A history of the current budgetary process was researched, along with applicable laws and regulations. Investigative reports from the GAO, the DoD IG, congressional hearings, and personal testimony were reviewed to determine the extent of qualitative data available. Contemporary management-and-public-policy theory was reviewed to find theoretical support or refutation of claimed inefficiencies and waste. Agency theory was applied to both the question of year-end spending and the proposed carryover plan. Finally, structured interviews were conducted with DoD financial executives, management, and contracting employees for a range of perspectives on year-end spending and the perceived impact of carryovers.

## **E. SCOPE**

The scope of this project is limited to the federal government only. While state and local case studies are cited, it is not within the confines of this project to make policy recommendations at these levels. Similarly, several types of government funds are discussed, but conclusions are intended to apply to operations and maintenance funds only. Finally, several proposed changes to the appropriation process are cited in this research, but conclusions regarding the carryover incentive proposal are alone attempted.

## **F. ORGANIZATION**

Chapter I provides an overview of the project: its purpose, objectives, and scope. A description of the research questions and methodology used to draw conclusions is provided. Chapter II reviews the history of O&M appropriation, citing applicable laws and regulations. Chapter III analyzes the current system by reviewing the literature and applying contemporary management, public policy, and political theory. Chapter IV presents different forms of carryover incentives, especially as enacted in nonfederal entities, and a theoretical basis for the proposed incentive. Chapter V describes resistance to the carryover incentive and the reasons for it, and outlines a rationale for change. Chapter VI presents conclusions and makes a recommendation.

## **II. HISTORY OF THE ONE-YEAR APPROPRIATION**

### **A. CONGRESSIONAL ORIGINS**

The United States Constitution, Section 8, grants Congress the authority and responsibility to fund the military: to “provide for the common defense and general welfare of the United States... to raise and support Armies, but no appropriation of money to that use shall be for a longer term than two years” (U. S. Constitution). The origins of the current one-year obligation for operation and maintenance accounts start with the first general-appropriations act in 1789; “Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, that there be appropriated for the service of the present year, to be paid out of the monies which arise...”(1 Stat 95). This original decree is popularly called the bona-fide need rule. But due to confusion over the timing of the requirements, in 1870 the “one-year” rule became the bona-fide-need statute (31 U.S.C 1502a), providing that the balance of the fixed-term appropriation “is available only for payment of expenses properly incurred during the period of availability or to complete contracts properly made within that period.” A further basis for the year’s limitation is the Anti-Deficiency Act, 31 U.S.C 1341, which states that agencies may not spend, or commit themselves to spend, in advance of, or in excess of, appropriations (GAO, 2004). Comptroller General decisions and government regulations have solidified this law over the past hundred years.

### **B. THE INCREMENTAL BUDGET SYSTEM**

The current system used federally is incremental budgeting, in which the previous year’s budget or obligation rates serves as a basis for subsequent years’ budgets. The need to fund recurring requirements is the baseline for the budget; as mission needs arise, the baseline budget is adjusted incrementally to meet them. Operations and maintenance appropriations are authorized every year, and incremental adjustments are made annually in accordance. Incremental budgeting simplifies budget decisions because it requires close scrutiny of the increment only. The weakness of the system is that it assumes the

organization forever needs its full baseline amount. If an organization fails to use its entire baseline amount, it is logical to assume that the entirety is not needed and can be reduced.

### **C. YEAR-END SPENDING**

When an annual appropriations act is approved, agencies have until midnight on September thirtieth to obligate their authority. Authority that is not obligated expires and can be used only to pay for obligations rightfully incurred during the intended fiscal year of appropriation. This annual deadline entrains a huge effort on federal agencies that plan months in advance to execute as much authority as possible—or lose it. Agencies assume that greater funding will make achieving mission goals easier; fewer resources may mean mission failure and cancellation. There is therefore theoretically an incentive to spend as much as possible for survival's sake, and exhaustive spending may be regarded not only as the hallmark of a successful year, but a key criterion by which executives and financial managers are judged effective.

If funds are not obligated by the close of the fiscal year, balances cannot be used for new activities. In some cases, expired authority may be used to make adjustments to already incurred obligations or for recording previously unrecorded obligations related to a specific expired fiscal year. But for the vast majority of federal O&M-funded agencies, expired funds are held in accounts that cannot be touched for five years, after which the authority is cancelled and returned to Treasury.

In the final budgetary weeks, staff can get a better idea of what can be purchased and how much authority remains. Organizations that cannot execute funds usually have them allocated by higher-level agencies, which redistribute them to those organizations that can. A successful organization that intends to thrive will execute every dollar received. One interviewee for this project describes merchants and contractors camped outside contracting offices on September thirtieth, just in case money came through to fund their contracts. Another interviewee recanted a situation in 2005 where a Major Command in the Air Force unexpectedly dropped over \$1.1 million at his base with three days left in the fiscal year. The base was standing by with ample contracts and purchase

requests and spent all their new authority in under three days. Such sprees are reported as unremarkable throughout the DoD in the waning days of the fiscal year.

#### **D. APPORTIONMENT**

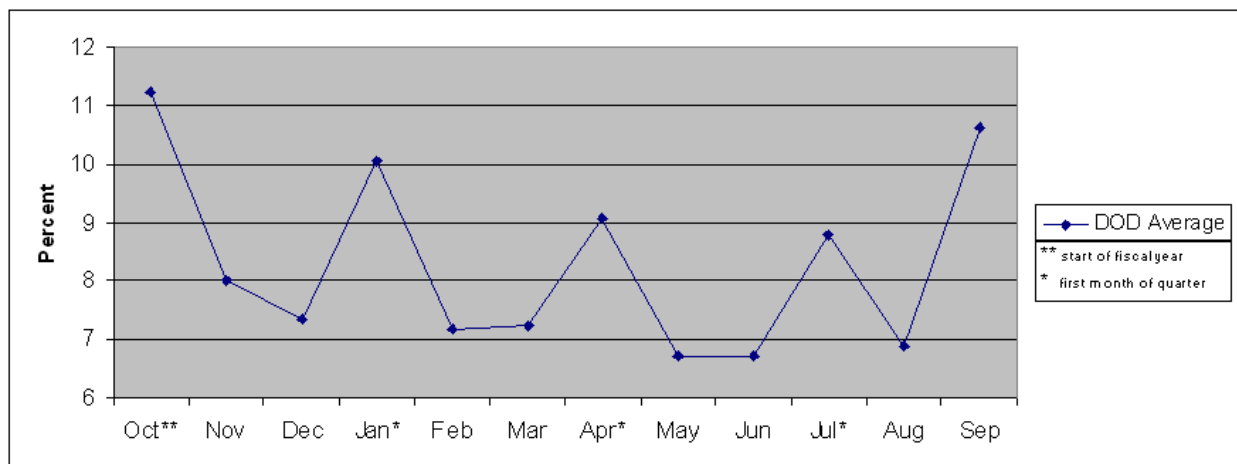
In the late nineteenth and early twentieth centuries, lawmakers realized that federal agencies often spent all their authority before the end of the fiscal year, forcing Congress to bail out the agency with supplemental appropriations or by transferring budget authority. In 1905, Congress addressed the need to prevent agencies from overspending their budgets by creating U.S. Code, Title 31, Section 1512, Apportionments and Reserves. The Act of March 3, 1905, 33 stat. 1257. was an amendment to the existing Anti-Deficiency Act (GAO, 2004). In enacting this statute, members of Congress emphasized that “we give to departments what we think is ample, but they come back with a deficiency. Under the law they cannot make these deficiencies and Congress can refuse to allow them; but after they are made it is very hard to refuse to allow them . . . we seek by this amendment to in some respect, at least, to cure that abuse.” 39 Cong. Rec. 3687 (1905) (statement of Rep. Hemenway). (Kepplinger, 2007, p. 4)

The apportionment legislation declared that an appropriation available for obligation for a defined period should be apportioned to prevent obligation or expenditures at a rate that would indicate a necessity for supplemental or deficiency appropriation for the period (McCaffery and Jones, p.218). Apportionment is the process of distributing authority in phases, which helps prevent spending spikes at the beginning of the year and prevent stockpiling funds at the end of the year. It regulates the timing of execution and attempts to ensure that agencies do not run out of money before the year is over.

Not until the creation of the Bureau of the Budget in 1921 as part of the Budget and Accounting Act of that year was the practice of apportionment actually put in place. The Bureau of the Budget started the process of apportionment in conjunction with the U.S Treasury, but it wasn’t until 1933 that Congress officially gave apportionment authority of yearly appropriations by months and quarters to the Bureau. Now called the

Office of Management and Budget, OMB distributes apportioned authority to the military departments and services once a quarter. According to Title 31, Section 1514, service and department secretaries are responsible for enacting regulations to distribute apportions to subordinate agencies. This process of apportionment causes a cycle of obligation surges throughout the fiscal year. Figure 1 shows quarterly spikes due to the apportionment process. Apportionment has succeeded in slowing down spending, but because it causes agencies to wait for their authority, it limited agencies' ability to obligate funds in a timely fashion. Many feel that the time allowed to obligate funds is already too short and that apportionment further restricts agencies' ability to obligate funds in a timely manner.

Figure 1. DoD Monthly O&M Obligation Rates 1970-1993<sup>1</sup>.



<sup>1</sup> Kozar, 1993, p. 135.



Table 1. Average DoD Operations and Maintenance Monthly Obligation Rates with High-Low Ranges (Percent) 1977-1990<sup>2</sup>

Month	DOD Average	High	Low
October **	11.235	12.3	9.83
November	8.018	9.73	7.03
December	7.346	8.18	6.47
January*	10.048	11.42	8.11
February	7.165	8.35	6.1
March	7.223	7.96	5.65
April*	9.083	10.61	8.3
May	6.708	7.61	6.09
June	6.726	7.49	5.89
July*	8.778	10.57	7.43
August	6.887	7.39	6.17
September	10.616	12.05	9.78
<b>Total</b>	99.833		

#### E. 80-20 RULE

If the Apportionment Act was meant to slow down spending, the 80-20 rule is meant to speed it up. Each year as part of the annual appropriations act under the general instruction, the 80-20 rule is required by language in annual appropriation acts. (Potvin, 2007). This law states that federal agencies are to have 80 percent of their total budget authority obligated by July thirty-first. The 80-20 rule prevents agencies from stockpiling funds until the end of the fiscal year so they can purchase big-ticket items. It also helps high-level agencies account for obligation rates and make year-end closeout plans. There can be exceptions to obligation-rate timelines, so DoD agencies are required to provide an execution plan at the beginning of the year, and on a regular basis they must match their actual obligation rates against the plan. This is intended keep agencies honest during execution budget. Any deviation from the projected rate of execution must be

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<sup>2</sup> Kozar, 1993, pp.132-133.

explained. With apportionment slowing agencies down and the 80-20 rule speeding them up it is clear they have diminished discretion to execute budgets according to mission needs.

## **F. “M” ACCOUNTS**

In 1989, Congress asked the GAO to report on the Air Force’s use of expired funds to make changes to the B1-bomber program. This issue came to the forefront of policymakers’ attention because Congress discovered the Air Force was planning to use \$1.1 billion out of “M” accounts to fund overruns to the B1B program. “M” accounts were essentially the final resting place of unobligated funds that expired unobligated. Before 1991, expired funds sat indefinitely in the treasury but the accounts themselves were maintained by the services. Congress had allowed the accounts to be used for minor cost overruns and within-scope changes to procurement programs. In its investigation, the GAO found that the Air Force was not in violation of law; but Congress did not like the fact that these funds could be used by the services without congressional oversight. Because the authority had no fiscal-year identity after two years, theoretically, unobligated balances could sit in “M” accounts indefinitely, until the services found a way to use them (GAO, 1989).

In 1991, Congress passed the National Defense Authorization Act, which changed the way expired funds are handled. This legislation requires expired appropriations to retain their fiscal-year identity in an expired account for five years. During this period, the expired account is available only to record previously unrecorded obligations and make adjustments in previously under-recorded obligations. Expired accounts can be adjustments both upwards and downwards, and in fact, it is the cumulative effect of these adjustments that contributes to the expiring balances. The GAO Comptroller General decision took up the issue and ruled that unobligated balances in expired accounts cannot be used to satisfy an obligation properly chargeable to current appropriations. At the end of five years, any remaining balances are cancelled and the account is closed. When unobligated funds expire at the end of the fiscal year, they are supposed to be tracked by the services. There is currently no government-wide system for monitoring or reporting

on unobligated appropriations. Treasury estimates that roughly \$16 billion is cancelled from expired O&M accounts every year (Conlon, 2006).

## **G. BONA-FIDE NEED RULE**

In 1901, the Comptroller of the Treasury determined, “an appropriation should not be used for the purchase of an article not necessary for use of a fiscal year in which ordered merely in order to use up such an appropriation.”(GAO, 2004, PP. 346-348). This decision has major ramifications in clarifying the bona-fide-need rule in federal budgeting. Based on this ruling, the annual appropriation is written into law each year and states that no money may be spent for future years’ needs unless those needs existed in the budgeted year. The question lingers how any purchase made in the final days of the fiscal year may be considered necessary for the year just ended<sup>3</sup>. The argument is advanced that goods or services that are not delivered until the next fiscal year, but were obligated for purchase in the ending fiscal year, violate the precedent on which bona-fide need was based; after all, the agency did get through the year without them. Currently, regulations allow for purchases that will be shipped in the next fiscal year. This paradox hints at the somewhat arbitrary nature of the 30 September cutoff date.

Over the years, the bona-fide-need rule has been debated back and forth. While more recent Comptroller General rulings have clarified the spirit of the law, questions about violations inevitably depend on the circumstances. In 1990, Congress enacted statutes redefining, in some instances, what constitutes a bona-fide need. Laws providing more flexibility in the use of bona-fide need in fiscal-year appropriations, as well as expanded regulations for the DoD, were passed (GAO, 2004). One quarter’s worth of supplies is set forth as a guideline for agencies; but due to the difficulty of estimating the rate of consumption, no exact pre-purchase grace period is legislated. Year-end spending on service contracts is considered bona fide in the waning days of the fiscal year if the contracted service is either a recurring seasonal requirement or addresses a need that was present during the closing fiscal year—but the contract must be for non-severable services in order to cross fiscal years. Contracts can be modified in following years and expired

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<sup>3</sup> Discussion based on discussion from Principles of Federal Appropriations Law, Chapter 5.

funds from previous years can be used as long as changes to the contract are within the scope of the original agreement<sup>4</sup>. Under these conditions, a purchase is considered bona fide.

## **H. ATTEMPTED CHANGES TO THE BUDGET SYSTEM**

There have been several attempts to change the incremental budget system used by the federal government and DOD. President Eisenhower sought to decentralize operational authority to combatant commanders, figuring they would be most knowledgeable about their requirements and the most motivated to accomplish their missions. The commanders did get operational and decision control, but in form only. The services retained administrative control over the forces and combatant commanders had to settle for whatever unit resources they were given to work with. In the end, the innovation increased bureaucracy and stifled its own purposes. (Cothran, 1993)

Another example of incomplete reform came under Defense Secretary McNamara with the Planning, Programming, and Budgeting System (PPBS), designed to reorganize DOD according to function rather than by standing units and personnel numbers. Under this plan, policymakers such as Congress maintained strategic oversight of what capabilities to pursue, but lower-level agencies were supposed to wield considerable discretion in accomplishing them. The idea was to push the power of decision down to the lowest appropriate level. Initially the plan was presumed to create a clear link between goals, performance, and rewards. Although PPBS was implemented, the system failed to decentralize the government to the degree intended (Cothran, 1993).

Along similar lines, defense comptrollers Charles Hitch and, later, Robert Anthony tried to install “results-oriented, operational budgeting” (Thompson, 1991, p. 55). An accounting structure proposed by Anthony was intended to be “firmly grounded in the principles of responsibility budgeting and accounting” (Thompson, 1991, p. 58). Aside from PPBS, which was only marginally successful, most of the proposed change never became fully operational, in part due to the preemptory difficulties of the Vietnam

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<sup>4</sup> GAO report dated September 1989 title Strategic Bombers B-1B Program’s use of expired Appropriations.

conflict (Cothran, 1993). These failures to “fix the system” have left a residue of frustration, and cynicism in the federal budgeting community. This attitude obstructs budgetary reform.

## **I. ZERO-BASED BUDGETING**

Zero-based budgeting (ZBB) was a form of performance-based budgeting highly touted in the early 1960s. It was meant to maximize efficiency and reduce waste and redundancy by forcing an annual justification of all expenditures rather than just the incremental changes customarily reviewed. Incremental budgeting was generally presumed to discourage review of existing expenditures simply because they had been in the previous budget. Proponents of ZBB argued that a continual refocus on all budget requirements was best for achieving mission objectives in a dynamic environment. “This shift was intended to emphasize the role of analysis as the basis for allocation decisions rather than subjective factors that might impede or obfuscate the process of arriving at an optimal resource distribution” (Peters, 2006, abstract). The new practice would generate savings because management had to review all expenses and excise needless items. “The fact that certain activities have been carried out for a number of years will not, per se, adequately justify their continuation”(Boyd, 1982, p. 430).

In 1964, the concept of zero-based budgeting was tried in the lower levels of the Department of Agriculture, but failed to take hold elsewhere for a number of reasons. First, agencies in the Department of Agriculture never dropped the assumption that all their programs were necessary or reformulated their budgets accordingly if they were not. Political considerations and poor legislative timing also hurt the proposal. Zero Based budgeting was once again tried under the sponsorship of Jimmy Carter during 1977-80, but was dropped by the Reagan administration in the early 1980's. (McCaffery, 2004, pp. 416-431). But probably the biggest reason for the failure of ZBB was that it disrupted management by generating mountains of extra accounting and paperwork (Handa, 2005).

This chapter has reviewed the historical background of the one year appropriation and the environment in which it has been developed. From the first budget Appropriations act of 1789 to current day there have been many successful changes to the

budget process as well as many failed attempts. The evolution of the budget and execution process has been impacted by countless unforeseen variables and has created a reactionary approach to change which in some cases create problems in the process of fixing others. A by-product of the current process is the year-end closeout process which many feel provides an occasion for inefficient and wasteful spending practices. In the next chapter year-end spending will be analyzed from a theoretical and practical perspective.

### **III. YEAR-END SPENDING ANALYSIS**

#### **A. AGENCY THEORY**

In understanding the relationship between the budget-granting Congress and the recipient federal agencies, agency theory is valuable. Agency theory holds that in a relationship between a principal and an agent, each will act according to its best interests.

An agent's agenda will often be at odds with a principal's, and when this happens, the principal will suffer some reduction in welfare. After initial losses stemming from the agent's actions, the principal suffers secondary loss in the cost of correcting the agent's behavior. The conditions that allow for hidden actions, hidden information, and principal vulnerability are known as Madison's dilemma. (Kiewiet, 1991)

In many adversarial principal-agent relationships, the agent has information that is unavailable to the principal or too costly to obtain. When the agent has incentive to use this information strategically or simply to hide it from the principal, incentive incompatibility arises. The information may be about business, people, or changes in the business setting. The enforced lack of knowledge will undermine the principal's decision making as he tries to increase his welfare, but it will not harm the agent. Moreover, hiding information and actions harms the principal doubly, because the advantages and achievements the agent enjoys thereby cannot be tracked accurately without his assistance. The agent has the power; he has turned the autonomy granted to him against the principal (Kiewiet, 1991).

When the principal discovers the agent is acting against his interests, he has several techniques for remedying the situation. He can increase monitoring, change organizational structure, implement bonding, or alter the principal-agent contract (Douglas, 2006). Any of these actions might be the right move in the circumstances, but mismatching problems and actions can prove disastrous. Increased monitoring is best for addressing information asymmetry. Organizational change is useful in eliminating process breakdowns or potential waste in ineffective organizations. Bonding ensures that

the agent declines certain actions that would harm the principal and also holds the agent responsible for compensating losses (Kiewiet, 1991). The ultimate action a principal can take is to change the contract, renegotiating a deal that works for both parties.

The principal, in this case, is Congress, which seeks to delegate tasks and responsibilities to the agency level and at the same time specify a compensation plan such that the agent is sufficiently motivated to serve the principal's interest (Kiewiet, 1991). The resulting contract must specify both rewards and sanctions, because the principal is vulnerable to harm by the agent. The further the agent is from the principal's sight, the greater the severity of sanctions. Positive rewards, however, are not magnified. In some cases, the effort required of the principal to monitor and sanction the agent is greater than the benefit gained (Kiewiet, 1991).

Designing effective compensation-and-punishment plans in the principal-agent relationship can be tricky anywhere, but in the government sector it can be more confounding, due to legal restrictions on management that prohibit personal rewards or punishments. Outside government, the problem of inappropriate compensation incentives can be mitigated by offering the agent a residual claim of the output. This is not possible in the government system because the output is usually intangible. While some monetary rewards are offered to civilian employees, their impact is often diminished because rewards are not given promptly and much of the behavior that earned the reward is forgotten. Monetary rewards are not offered to military at all. The hierarchy of agency relations further compounds this problem as higher level agents are charged with the responsibility of designing reward systems for subordinate agencies. Thus, Congress is further limited from impacting the behaviors at the field agency level.

These strictures make it more difficult to motivate government employees, but not impossible. They can be rewarded by removal of stress, honoring of good behavior, and promotion or advancement. Removing stress can be achieved many ways, such as lightening the workload, allocating more resources to a task, and improving tools and surroundings.



Honoring good behavior involves institutional formalities such as decorations and other symbolic gestures that celebrate group or individual accomplishment. When good behavior is celebrated, agents are encouraged to behave well. It also spurs healthy competition with peers and a positive-feedback loop develops.

Promotion and advancement usually depend on an agent's mastery of current tasks and readiness for more advanced assignments, and generally carry the reward of higher pay.

By selecting only those agents whose behavior protects the principal's interest, the principal ensures that agency leadership will espouse values consistent with those interests. By basing rewards contracts on an agent's desirable performance, the principal is more likely to ensure positive performance, "After all, there is no better information about how well an agent performs than his or her actual performance" (Kiewiet, 1991, p. 29).

Even under the most effective contract between principal and agent, monitoring plays an essential role in the principal-agent relationship. Monitoring is the most straightforward way to eliminate the conditions that promote hidden action and information, which cannot remain hidden long if the agent is compelled to reveal them. But despite its advantages, monitoring has its risks. The transfer of information involved diverts time and attention from tasks the agent would otherwise be performing. Additionally, if the agent has an incentive and means to hide information, the principal may never know unless he conducts an investigation (Kiewiet, 1991). Any great depth of monitoring can cost the principal considerably in time, money, and reputation, and must be used sparingly for this reason. Monitoring may be done through an affected third party by using a "fire-alarm" system, by which serious violations can be brought to the principal's attention, e.g., through the fraud, waste, and abuse hotlines and drop boxes that go straight to agency executives (Kiewiet, 1991).

Another way a principal may protect his interests is through institutional checks. These often concern two agents: one with the responsibility to take action and the other with the authority to veto. For example, a principal might reward a manager for

productivity while rewarding a comptroller for saving money (it must be noted, however, that institutional checks break down if the manager is responsible for the comptroller's performance assessment). In the federal government, there is little incentive for a comptroller to save money—savings only hurt comptroller and manager alike. The manager is punished for saving because it represents lost opportunity to secure mission resources. The comptroller is hurt in two ways: his boss is often his manager; and the fewer resources that result from savings mean his job will be more difficult in the future.

## **B. PROBLEMS WITH THE ONE-YEAR APPROPRIATION PERIOD**

Critics cite the rush to spend as the primary flaw of the one-year obligation system. Year-end closeout is a high-profile event in every government agency, at every level, uniting politicians, commanders, contracting agents, accountants, budget personnel, contractors, office clerks, and vendors in a hectic campaign to use or lose forever. To add to the stress, the consequences of failure stretch into the future, because of the belief that tomorrow's resources will vanish along with today's. Strategy, speed, and preparation make the difference. Funds must be obligated in a way that adds as much benefit to the agency as possible without breaking any rules, as the clock runs down on a unbudging deadline and success or failure are displayed for all to see.

A recent study on how direct- and indirect-control systems influence agency behavior revealed that indirect controls, because of the influence of job-related stress, had a significantly higher impact on decision making than did direct-control systems on individual choices (Shields, 2000). It is no wonder that direct, regulatory controls become subordinate to the indirect control and incentives that precipitate the rush to spend. Amid the urgency of the clock, the fielding of unforeseen variables, an anxiety about one's career the risk to the agency's budget base and the comfort of next year's work environment, resources may well be spent non-optimally.

Low-priority purchasing for the sake of exhausting funds has been sharply questioned, both by those caught in the process and onlookers. Congress has asked the Government Accountability Office to investigate year-end spending practices on four

occasions<sup>5</sup>. In each case, the GAO found problems with year end execution and confessed an inability to oversee spending (GAO, 1998). The GAO also found that year-end spending compromises system controls, especially in contract management, which the GAO labeled “high risk,” with the note that poorly executed and monitored individual contracts are continually found. The GAO reported in 1998 that instances of improper spending had decreased due to new legislation, but also that a true accounting for year-end spending was still not possible—the systems used for reporting at the departmental level were not compatible with the treasury and the numbers reported in the systems did not match (GAO, 1998). Of special interest to this research is the GAO claim that a decrease in inappropriate year-end spending was attributable to the greater discretion Congress had recently given the agencies. Congress had reduced both the opportunity and need to spend quickly at year’s end by making funds available for longer periods in many appropriations (GAO, 1998).

The finding of one DoD Inspector General report was that year-end spending was directly responsible for inappropriate handling of funds<sup>6</sup>. In one case cited, the Army’s claims service incurred higher administrative costs by using the General Services Administration (GSA) because it was faster than the Army’s contracting office. The decision was made because, in a time crunch, the GSA can spend money fast. The GSA is paid for its ability to execute quickly, but they are not responsible for the proprietary execution of those funds. The implication of the DoD inspector general was that the Army contracting office would have been slower but more thorough.

### **C. EMPIRICAL EVIDENCE**

An interesting irony in the spend-it-or-lose-it syndrome is the absence of empirical evidence showing that subsequent-year cuts are based on previous-year

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<sup>5</sup> GAO reports 1998 “Year-end spending; reforms underway but better reporting and oversight needed”. 1985 “Federal year-end spending patters for fiscal years 1982, 1983, and 1984”. 1980 “Federal year-end spending: Symptom of a larger problem.” 1980 “Government agencies need effective planning to curb unnecessary year-end planning.”

<sup>6</sup> DoD Inspector General report FY02-109 (<http://www.dodig.mil/audit/reports/fy02-109.pdf>).

obligation rates<sup>7</sup>. This is not to say such a relationship does not exist—or could not exist—but only that documented cases are utterly lacking. What could explain this lack of evidence? There are three potential reasons: first, that the loss of baseline budget due to unobligated authority in previous years is simply an urban myth; second, that internal controls have been so successful at exhausting funds that unobligated authority is a rarity; third, that in the few cases when unobligated authority is left on the books, it is discreetly hushed because of the feared ramifications of such a “failure.”

It may be, in fact, no more than urban legend that unspent obligations lead to future cuts; nevertheless, the trepidation of losing the opportunity to spend funds, combined with fear of future budget cuts, appears to influence spending at the end of each fiscal year.

#### **D. HISTORICAL PERSPECTIVE**

The complexity of the federal budget system stems from over 200 years of shifting requirements and alternating players. As such, the existing system is the amalgamation of all budget-process decisions made throughout the nation’s history. Aaron Wildavsky summarizes the impact of these circumstances: “The line-item budget is a product of history, not logic. It was not so much created as evolved, and as such it is not consistent or complementary” (1978, p. 501). There have been 110 congressional sessions and 43 presidential administrations, and each Congress and President has shaped the budgeting system in response to the events and politics of the time, whether for long-term good or ill.

When the U.S. Constitution was written, the American population was 2.5 million persons<sup>8</sup> and the entire federal budget was \$639,000<sup>9</sup>. Guidance on the appropriate use of public funds was vague because of the limited size of government “No Money shall be

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<sup>7</sup> A panel of budget experts addressing this topic in the International Public Management Network Symposium concluded that there is no empirical evidence to support the spend it or lose it belief. See Jones, 2005 reference for more details.

<sup>8</sup> Population institute website, retrieved on 27, September 2007 from <http://www.populationinstitute.org/newsroom/population-news/?id=42>.

<sup>9</sup> General Appropriations Act of 1789 1 Stat. 95.

drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time” (U.S. Constitution, Article 1, Section 9) .While the original principles still apply, the laws and policies enacted to direct federal budgeting have been overwhelmed by the nation’s growth (Kiewiet, 1991, p.22). As the nation grew, Congress added laws, organizations, and requirements to keep pace. Each change modified or added to the old system. This practice of compiling, rather than reforming, has added layer upon layer of bureaucratic confusion.

#### **E. A THEORETICAL PERSPECTIVE**

Applying agency theory and other contemporary management control principals to year-end spending reveals that the problems of the one-year obligation persist because of incongruence between the principal (Congress) and agent (federal agencies)<sup>10</sup>. Critics argue, per agency theory, that year-end spending forces agencies to obligate funds to protect the organization and its leadership, in effect, hiding the information that there are monies left over. Higher obligation rates protect budgets from inexpedient cuts, potential future cuts, and perceived failure. Agencies that rush to spend are acting rationally, because they perceive they will be penalized for not obligating funds.

On the other side of the relationship is Congress, the principal. One problem with Congress as principal is that Congress is neither consistent nor rational; it is a body of over 500 disparate and competitive representatives, who are, in effect, 500 principals. The presence of multiple principals complicates control-system analysis because each principal has their own interests which may or may not be in line with the goals of the agency. The current system benefits many in Congress because it enables devices such as earmarks and other tools for Congressional representatives to fund project that are advantageous to their constituents (Schor, 2007). It is likely that many congressional principals are satisfied with the current system, despite its acknowledged inefficiencies.

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<sup>10</sup> Statement summarizes Merchant and Van der Stede Chapter 11.

If Congress were rational, members might argue that an agent should not spend what it does not need and should allow residual authority to expire and become available for future funding. But many congressmen resist this argument because the authority would remain unavailable for five years, till it is actually returned to the treasury. By that time, many incumbents will be out of office and the savings will not have been useful to them. Funding is a near-term means for Congress to control federal agencies through the power of the purse. The interrelationships between Congress and federal agencies are anything but clear; but the potential for incongruent agendas between Congress and the federal agencies is plain.

By design, Congress is partially reconstituted every election year, whereas federal agencies are relatively stable, with processes and missions that encourage a steady course. This paradigm has allowed agencies to develop fine maneuvering skills within Congress's system of controls. Savvy organizations hold off low-priority purchases until the end of the fiscal year, legitimately achieving the greatest possible gain from the budget given. The rub arises when in the chaos of year-end spending, convenience trumps priority and purchases are driven by a determination to go broke rather than mission need.

## **F. SLACK RESOURCES**

Organizations may game the system through the creation of slack resources, that is, spending on insignificant products and services to create a cushion in the baseline to exploit in future years (Merchant, 2003, p.559). This slack not only inflates the budget, it almost guarantees an organization will grow beyond its intended purpose and goals.

Principals tend to look at the creation of slack resources with disdain—but perhaps budgetary slack is not all bad. A study by W. A. Van der Stede came to three conclusions about budgetary slack and its impact on agency success. First, it was found that rigid budgetary controls reduce slack. But reduced slack makes short-term budget targets more difficult to achieve, which in turn, may drive managers to focus primarily on actions that win short-term results. Second, organizations that have a strategy of differentiation in budget styles seem less constrained by rigid budgetary controls and

restricted resources. This freedom allows them to pursue the critical success factors on which their strategies are built. Put simply, flexible budgets, which slack often provides, allow for innovation and flexibly. Finally, research found that managers of poorly performing business units are more affected by rigid budgetary controls, have less leeway to build slack, and are concerned primarily about issues that affect short-term results (Van der Stede, 2000). It appears that slack has advantages, despite its negative press.

#### **G. CONGRESSIONAL INTEREST IN YEAR-END SPENDING**

Congress's primary means of governance is through legislation and control of finances; Congress has the power of the purse and the responsibility of ensuring that the public interest is served at all federal levels, including field activity. Where there is waste, Congress is responsible for instituting and promoting policies for reducing it. If there is no immediate problem, Congress is still responsible for reviewing laws and processes to determine when and if changes may be beneficial. It is this responsibility to strive towards better governance that leads Congress to evaluate its techniques for controlling how agencies spend their money.

At a congressional hearing in 2006, Senator Coburn of Oklahoma asked for a plain answer as to whether federal agencies have a use-it-or-lose-it mentality during year-end closeout. The agency representatives in attendance acknowledged some level of rush to spend, but more importantly offered valuable insight into the phenomenon. The Department of Veterans Affairs representative Robert J. Henke claimed that in the past there had been a use-it-or-lose-it rush but "some accounts had a two-year limit precisely to avoid that situation." (Conlon, 2006, p.1) Charles E Johnson, Assistant Secretary for Budget, Technology and Finance at the Department of Health and Human Services, stated that he never saw it happen with two-year money, but he did see a "rush to obligate" with one-year money, in which circumstance funds might not be spent on the highest priorities. He went on to testify that as of September 30, 2005, about \$430 billion in unobligated funds existed government wide. (Conlon, 2006) Of these funds, \$376 billion were from multiyear and no-year funds, but another \$54 billion came from expired accounts—primarily from operations and maintenance funds. The treasury has estimated

that in 2005, \$16.4 billion was returned to the treasury after being cancelled or in unspent obligations (Conlon, 2006). Just under \$2 billion of this sum came from operations and maintenance accounts for the Department of Defense (OMB, 2007).

## **H. CONGRESSIONAL MICROMANAGEMENT**

Another rationale for changing the current system concerns not funding so much as decentralization, and empowering agencies with more flexibility to accomplish their missions. Studies cited by Dan Cothran have found that policymakers are spending more time directing agencies at the field level than in previous eras. “Although there is evidence of movement towards a more decentralized approach to budgeting, empirical evidence actually suggest greater micromanagement by Congress and other principal agents” (1993, p. 450). Studies by Robert D. Lee in 1991 found that legislators and central-budget officers had increased their control of both the goals and limits of subordinate agencies. Compared with a previous study in 1970, in 1993 they were more apt to specify priorities, dollar ceilings, and procedural guidance, telling agencies how to prepare budget requests. At the DoD level “Congress saw micromanagement as a necessary and natural response to the Defense Department’s failure to manage its own affairs” (Cothran, 1993, p. 449).

Part of this increased oversight into agency-level operations comes from new technologies and greater access to information. The internet, email, and super-databases have given Congress the ability to oversee government spending at its finest details, and this fact has changed congressional perspective from oversight to micromanagement. Computerized accounting systems, in theory, give Congress an unprecedented ability to scrutinize field-agency operations and decisions. With a few keystrokes, congressmen and staffers can access any financial information they want—or if immediate numbers or answers are not available, can email a congress staffer who will direct an agency to provide the data. These “taskers” consume an incredible amount of manpower and resources but often amount to little or nothing. Oversight is important, but is there a point where minute oversight becomes merely burdensome and distracting for both Congress and the federal agencies? (Jones and Bixler, 1992).



## **I. MEASURING THE QUALITY OF YEAR-END SPENDING**

Perhaps the hardest part of analyzing year-end spending is evaluating the quality of purchases. Context is everything; and decisions are often reactions to the need of the moment rather than planning. As a typical example, every few months, budget offices are approached for new software or hardware because a higher level agency has decided to upgrade system requirements. Suddenly, a purchase that was not even on the list jumps to top priority. Conversely, high priorities may be downgraded when a leader departs a base and takes his pet project with him. An outsider will never completely grasp the purchasing dynamics of any given agency. Congress has established laws to prevent some inappropriate purchases—but at the end of the fiscal year, when funding availability and priorities change by the minute, even the best-laid year-end plan may go astray. One interviewee stated, “As it is now, requirements are funded as they pop up, allowing for some of lesser priority to be funded above higher priorities.”

As part of the research for this project, interview subjects were asked, “How would you measure the quality of year-end spending?” The consensus was that, absent flagrant abuse that no one could miss, there is no practical way of weighing year-end purchases—and the available literature suggests the same conclusion. What has been determined by the GAO and others is that processes do break down, which increases the chance of poor decisions but does not prove the actual occurrence of year-end waste. This is not to conclude that poor purchases do not occur, but only to suggest the difficulty in recognizing them. It might also be the case that there is no evidence in part because there is a disincentive to report it.

This chapter has offered support for the assumption that year-end spending is a problem by citing historical, congressional, Treasury, GAO, and anecdotal acknowledgment and complaint. Whether the catalyst is perceived loss of opportunity, rushed decisions, or low-priority spending, the question remains whether something can be done. The next chapter analyzes a proposed extension of the obligation period by offering carryover incentives to organizations that have unobligated authority at end of fiscal year.

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## **IV. THE CARRYOVER INCENTIVE**

### **A. EXTENDING THE OBLIGATION PERIOD**

There is no doubt that the current system, however badly, works. For over 200 years, the federal government has used one-year obligation, and the United States has yet to collapse under flawed budgetary policies. Proponents of the status quo argue that it functions and that there are too many issues and uncertainties involved in changing it. Why, then, do analysts claim a need for reform? (Jones, 2003). And if it were changed, what would be the benefits?

Lawrence Jones, Professor at the Naval Postgraduate School argues for extending the obligation period of operations and maintenance funds by up to twenty-four months (2005). Jones and similarly convinced colleagues assert that extending the obligation period for as much as an additional year would allow agencies to obligate funds without arbitrary deadlines, thus relieving the pressure to spend at end of fiscal year and encouraging efficient practices. The two-year period in question should not be confused with biennial budgeting. Unlike biennial budgeting, the Jones plan would still mandate annual budgeting according to an incremental budgetary system. The difference would be that agencies would have twenty-four months to obligate. Additionally, by commanding two years in which to obligate funds, organizations would have two fiscal-year budgets for their needs.

The Jones plan may be seen as a return to the letter of the Constitution—and indeed, if the Founders allowed two years<sup>11</sup>, why should the historical narrowing of the window be seen as final? As Rob Laking of Victoria University of Wellington wryly expressed it; “It’s never really been clear to me why the natural rhythm of public spending should equate to the time it takes the earth to circle the sun” (Jones, 2005, p. 142).

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<sup>11</sup> Article 1, Section 9 of the U.S. Constitution allows for up to two year to obligate an appropriation.

Congress favors one-year obligation because it gives members control over agencies and flexibility for Congress to review and change funding and policy, and Congress is correct to guard these prerogatives. The point must therefore be clearly understood that extending a two-year obligation period is not the same as biennial budgeting: it does not affect the annual budget process, but only the time allowed for execution. Recent successes at the state and municipal level have shown lawmakers that they need not fear loss of control. Under the proposed obligation, Congress would maintain fiscal jurisdiction while increasing the value of monies appropriated of their more effective use.

## **B. THE CARRYOVER INCENTIVE**

The carryover incentive analyzed in this project differs from the twenty-four month obligation period only slightly. Instead of guaranteeing agencies additional time to obligate their funds, this plan requires that they actually close the books at the end of fiscal year, but agencies would retain the previous years unobligated authority for one-time or emergency use for the next twelve months. Using previous-year authority to fund ongoing operations in the subsequent year would mask the actual baseline needs of the agency. Conversely, using a separate pool of authority to pay for one-time and emergency funding would clarify the agency baseline. Under the current system, these exigencies constantly throw budgets off, making a real baseline nearly impossible to determine. The carryover incentive would stabilize agency budgets and allow managers to plan more accurately. The actual amount carried over would represent a very small portion of the actual budget, and limits could be placed on how much could be carried over. Canada, for example, has had 5% carry forward limit for its federal agencies since 1987 (Treasury Board, 1995).<sup>12</sup>

The proposed carryover incentive is not complicated, but there may be confusion about what form it will take and its impact on agencies. Hesitation and discomfort are natural given the dismal history of budgetary good intentions, and the mistaken

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<sup>12</sup> Treasury Board of Canada, [www.tbs-sct.gc.ca/report/orp/1995/gwr-1995\\_e.asp](http://www.tbs-sct.gc.ca/report/orp/1995/gwr-1995_e.asp) retrieved 1, October 2007.

identification of a two-year obligation period with the failed biennial budgeting. Through the interviews it became clear that many individuals are so accustomed to the process created by the one-year obligation period that it blinds their ability to perceive a two year window of availability or a carry over incentive.

### **C. ENTREPRENEURIAL GOVERNMENT**

In the higher levels of the federal government, we have seen a growth of interest in the entrepreneurial model. One success is the Working Capital Funds (WCF). WCFs were created to keep inherently governmental work within the government while taking advantage of the commercial-market demand and efficiencies of industry. There are currently five WCFs in the Department of Defense. According to the OSD comptroller, each year the WCF does over \$99 billion in business, roughly 24% of direct appropriations<sup>13</sup>.

Working-capital funds are unconstrained by time limits. They are held directly accountable for keeping costs down and competing in the commercial marketplace. This investiture of responsibility has spurred innovative business practices and led to much more agile and capable services, such as repair depots, for the federal government. There are many differences between WCF programs and O&M budgeting, but the success of WCFs shows that government agencies can be very successful when allowed to handle their funds in an entrepreneurial fashion.

### **D. AGENCY THEORY AND THE CARRYOVER INCENTIVE**

We have discussed agency theory and the carryover incentive program. Applying agency theory to the carryover plan will identify benefits and detriments in the proposed reform.

As stated earlier, Congress has a few techniques for promoting good stewardship but not all actions that it could take would be wise. In the case of solving the year-end spending dilemma, the use of monitoring, organizational change, and bonding have

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<sup>13</sup> Department of Defense official website, retrieved 1 October 2007 from <http://www.defenselink.mil/comptroller/center/dwcf/dwcfintro.htm>.

serious deficiencies. Monitoring is already underway in the form of regular reports and multilevel reviews of contracting and purchase transactions. These redundant inquiries and mandatory reporting procedures, coupled with computerized access, grant principals instant information. There is so much information to monitor that it becomes difficult to manage while still planning and leading the nation. “By reducing the amount of time they spend examining detailed line items, they (Congress) will have more time to monitor actual program performance” (Cothran, 1993, p. 446)

Using organizational change to promote good practices is not a workable solution because it would have to be implemented at the field-agency level. There is no way Congress could intervene in this microcosm of the federal government, and even if they could they would provoke resistance from the agencies (Douglas, 2006). Nor would bonding work, because the process of generating bonded agents is extremely difficult, and agents would resist the risk of accountability for decisions made outside their control.

The final approach to the year-end spending dilemma is contracting, which is the recommendation with which this paper is chiefly concerned. Modifying a contract between Congress and a federal agency is not the same as altering a private-sector contract. Both principal and agent are under the federal purview, which makes adjusting contracts more burdensome. To revise a contract, Congress has first to agree on the exact nature of the change, which necessitates debate; in the private sector, a decision may be made unilaterally or by board of directors. Contracts provide incentives to each party to accomplish a specific task. The principal offers incentives to the agent as best meet his own goals, whether they be financial incentives, moral (dependent on both parties’ agreement as to what right behavior entails), or coercive (punishment for acting against the principal’s interests [Douglas, 2006]).

All these incentives are instrumental in the relationship between Congress and the federal agencies. Financially, agencies need resources—and Congress needs to know how much to appropriate. Among moral incentives is that of fulfilling the public will. In the vast majority of perceived monetary abuses, the question is not about legal or regulatory violation, but the morality of whether a purchase should have been made. The presumption is made that each individual has character and will act in the best interests of

both the citizenry and the agency. The agency exists to support the people, and is therefore subordinate to the public good; moral issues only arise when agency interests are put first. Granting agencies discretion over expired, unobligated funds is a simple measure that aligns the interest of the agency with that of the Congress, which represents the public. Purchasing as a moral issue is disarmed, because both parties are incentivized to saving funds.

Under the present system, policymakers do not know whether a given surplus results from careful fiscal husbandry or an excess of funding. When faced with this black box, they must decide whether to take away authority in the next year, leave it unchanged, or reward the agency for good stewardship. The choice the principal makes has a dramatic impact on agent behavior. Agents view change in any direction as a signal from Congress. A reward for savings is a positive signal and will likely encourage greater savings. A punishment for savings will yield decreased savings; and no action reinforces the status quo. This arithmetic promotes the creation of slack resources—an organization is safe as long as it spends all its authority.

According to agency theory, the perceived need to create slack resources is significantly diminished if there is no penalty or disincentive for saving and an incentive for spending wisely. In addition, greater discretion and planning at the field level rewards the agency by assisting mission fulfillment. By offering the agent flexibility in the deployment of his resources, the principal may reasonably expect a burgeoning of entrepreneurialism and adaptability in the satisfaction of his interests. These qualities are important to the DoD, where budgeting is tied to warfare, and warfare is both vital and volatile.

## **E. DISADVANTAGES OF THE CARRYOVER INCENTIVE**

The carryover incentive has two primary drawbacks. First, savings incentives that promise money for retention at a lower level may restrict use of these savings at a higher level, where a greater need may be. Under the current system higher level agencies can consolidate money and direct authority where it is needed most. While there is potential for a conflict of interest between field level agencies and higher level agencies,

it is customary in the federal government to have funds realigned at any time in the year. The impact of the carryover system on this practice seems minimal. The second drawback is that surplus dollars may be the fallout of poor planning, and rewarding agencies would encourage further incompetence. Continued monitoring of budget execution under the existing control system should help to prevent this from happening.

The carryover incentive, as a reform, has the weakness inherent in any reform—that beneficial things may be lost. In the current system, inappropriate spending and poor planning are supposed to be punished, but it is sometimes not the case as this behavior is not often identified. Additionally, depending on the efficiency of the agencies' close out process, once a year unused funds can be redistributed to meet higher priority needs. (Douglas, 2006). Any carryover reform should retain these advantages.

#### **F. THE OKLAHOMA CARRYOVER PLAN**

In 1997, in response to perceived abuses of year-end spending, the Oklahoma legislature allowed state agencies to keep their end-of-year balances. Prior to implementation of the carryover program, funds that were not obligated by end of fiscal year were returned to the general fund in the state treasury. It was believed this loss of unobligated funds led to an annual rush to spend. The new plan allowed agencies to retain unspent appropriations for up to 16.5 months beyond the end of the fiscal year, effectively opening an appropriation window of 28.5 months to obligate annual appropriations. In writing the law, the legislature specifically used the term “surplus funds,” which gave it the flexibility to discontinue granting carryover appropriations if the agencies generated more carryover money than they really needed or took part in unacceptable spending practices. (Douglas, 2006). The law also stipulated that in early June, state agencies are required to report to the office of state finance with an estimate of the surplus funds they expect and why the surplus occurred. On the fifteenth of November, all prior-year obligations had to be expensed because the remainder would be reprogrammed as it transferred into the carryover account. The rules for using the carryover monies required the expenditures to be non-recurring purchases, to prevent the



carryover account from funding regular operating expenses. If the funds did not get used in the 28.5 month period, they were cancelled and fell back to the state treasury.

The program has now been in effect for ten years. Feedback from state agencies indicates considerable success. Most agencies now have a buffer to pay for one-time expenses they would previously have used current-year appropriations for. This buffer has stabilized budget execution and made it more predictable. Interviews of agency executives revealed that carryover moneys amounted to about one percent of an agency's annual appropriation. The most common use of the carryover fund was on non-capital equipment and computer and technology purchases. In general, the observation that "the utility gained from each dollar is increased when greater flexibility allows agents to deal with unexpected expenditures" (Douglas, 2006, p. 58) was resoundingly endorsed.

Agencies under the Oklahoma carryover plan reported substantial benefits. Greater flexibility in agency spending was asserted by 82.5% of those surveyed, and 72.5% claimed reduced wasteful end-of-year spending. The downside of the program cited included increased paperwork and the fear of future cuts. But only 17.5% of the agency employees cited these negative impacts. Table 2 shows the full results of the survey of state agencies on their perceived cost and benefits of the program.

Table 2. Benefits and Costs of Carryover Funds in Oklahoma<sup>14</sup>

Benefits and Costs of Carryovers Funds in Oklahoma	
<b>Benefits</b>	
Give Flexibility of Spending	82.5%
Reduces Wasteful end-of-year spending	72.5%
Encourages Savings	67.5%
Improves planning	67.5%
Those reporting three of four benefits	67.5%
Those reporting no benefits	2.5%
<b>Costs</b>	
Paperwork	17.5%
Worried about Future cuts	17.5%
Balances or appropriations were cut	12.5%
Spend down to avoid cuts	5.0%
Lack of discretion when reprogramming	5.0%
Spending caps	2.5%
Waiting to reprogram \$ until 11/15	2.5%

#### **G. WASHINGTON STATES SAVINGS INCENTIVE PROGRAM (SIP)**

The greatest success in carryover funds may belong to Washington State, with its Savings Incentive Plan. The SIA was created by Governor Locke in 1997 to find money for education, encourage the efficient use of state funds, and limit year-end-spending waste. By allowing agencies to keep a portion of their unobligated balance from each fiscal year in an SIA, agencies are encouraged to save at the end of the fiscal year rather than spend on low- or no-value-added purchases. SIAs are held in the general fund and used only to improve service to their customers. Pam Davidson of the Washington State Office of Financial Management described the situation as follows.

Because agency appropriations lapse at the end of each fiscal year, there was a known practice that some agencies would go out in the last several weeks of the year and buy goods/services just so as not to lose the money. They might buy reams of paper and boxes of pens, or they might buy new computers, etc. Sometimes this spending was done without much assessment of what the agency really needed. (Davidson, 2007)

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<sup>14</sup> From Douglas, p.57.

Under the SIA, agencies get a second chance to spend the money; they keep half of their “non-proviso” (non-earmarked) funds. One-hundred percent of the unobligated, earmarked monies go to education construction. There is a lag of about five months between the day the fiscal period ends (June thirtieth) and when agencies get their allocations (usually early December). When the appropriation expires, the unobligated balances are transferred to a general-fund account for three months to give the agencies time to close the books from the previous year. It takes the state an additional two months to complete calculations and generate the report that the Office of Financial Management (OFM) is required to deliver to the state senate on the first of December (RCW 43.79.460). Once the funds are in savings accounts, they are put in short-term investments by the state treasurer, with the accrued earnings going to the general fund rather than agency accounts. This ensures that the funds do not lose value due to inflation. In the decade the program has been in use, from FY 1997 through FY 2006, the educational savings account has received \$311.1 million. Over the same ten years, agencies have received a credit of \$44.7 million total in their SIP accounts. At the end of 2006, only 22.6% of these savings have actually been used. “Many agencies have already dipped into their savings account, while others are still saving up for a big purchase. The savings accumulate indefinitely. Agencies can now plan to pay for things that they’ve never been able to afford or to get added to their budget” (Davidson, 2007). It would be possible for the legislature to raid the account, but that has not happened in the ten years this program has existed.

The second goal of this program is to funnel more money into state education programs. Under the plan all unobligated “earmarked” money and half of the agencies unobligated balance goes to education. According to Davidson, “There are two winners—agencies and education [both K-12 and higher education construction is funded, in part, with these monies]. I would say that the program has definitely lived up to the original expectations” (Davidson, 2007). State agencies utilize the program in various ways. Some use it strategically and plan year-end purchases around it, while others don’t have big enough savings to affect their planning. “Some agencies feel it is of

great benefit, and some feel it is pretty irrelevant to them.... the education side of it has benefited greatly, so most policymakers here consider it to be quite successful” (Davidson, 2007).

Once placed in savings accounts, the money is no longer appropriated funds, which mean that use of the funds is not dictated by policymakers. There are, however, limitations on the use of the funds once they become available to agencies in the SIA. The funds must be used for “improving service to customers,” specifically in the areas of employee training, technology, and work-process improvements. It cannot be used for ongoing programs, so it cannot be used for staff, unless the staff is short-term. In practice, these funds have been used for a variety of purposes, including construction of new buildings, awards, computers, and training. It seems that as long as the funds are a one-time expense, justification expectations are fairly loose. Aside from these restraints, agencies are given considerable discretion to do what is best for their organization.

Agencies are encouraged to strategically plan the use of their savings funds even if it means waiting up to ten years or more, as is the case for about a quarter of the agencies. That is to say those thirteen state agencies have not touched their SIA in ten years of availability. When asked why they have not spent the money Ms. Davison responded “they might not use this money because they are letting it accumulate to a larger total, or they may just still count on using their direct appropriation first, and save this as their own little rainy day account for when they really need it” (Davidson, 2000). Part of the reporting required by state lawmakers required a survey of agencies to determine what impact, if any, this program had on their agencies at fiscal year end. The responses varied from no impact to significant. None of the 51 agencies reported a negative impact. One third of the agencies (17 of 51) stated that it had a positive impact. The remainder expressed little or no impact. Reasons accompanying a grade of “no impact” fell into two categories: either “we have always used our money prudently” or “we needed every penny and had none left unobligated.” The most positive response came from the office of the senate itself: “The SIA rebates have provided an incentive for

us to reduce expenditures, particularly those at the end of the fiscal year in order to enhance our SIA revolving account for unanticipated one-time expenditures” (Davidson, 2007).

Punitive budget reductions have not materialized as feared. “If we did it would be another disincentive for agencies to not participate in the program. Both the governor and the legislature want to preserve the incentive for agencies, because there is such a large benefit to education construction in this program” (Davidson, 2007). If the principals were to raid the account, agencies would quit saving and education would be the biggest loser.

Autonomy and discretion are conspicuous components of this program, whether intentionally or not (there is no oversight authority over purchases). The request process is not formal, and no inappropriate use of accounts has been reported; nor has there been any reported rejection of planned purchases using the SIA. Where there is a questionable purchase, the office of financial management is consulted, and if necessary the state attorney may be asked for review. It was not clear whether agencies decided against a particular expenditure after talking with the OFM and state legal office. Another reason no request for SIA expenditure has been rejected may be that agencies know they will have to detail their spending each year in a public report, which provides a substantial disincentive against doing anything against the spirit of the program and the law.

Despite the success of this program, its reputation has not traveled far. Some other states have shown interest in the program, and even other countries, but the general public largely unaware of what the radical departure represented by the Savings Incentive Accounts in Washington State (Davidson, 2007).

Table 3. Washington State Appropriations Compared to Actual Expenditures<sup>15</sup>

Washington State General Fund State – State Appropriations Compared to Actual Expenditures		
Biennium/Year	GF-S Appropriations	GF-S Actuals
1989-91	12,877,546,448	12,822,278,134
1991-93	15,276,996,675	15,179,946,506
1993-95	16,419,247,997	16,315,126,491
FY 1996 <sup>1</sup>	8,649,982,538	8,619,568,427
FY 1997	9,112,843,950	9,051,113,910
FY 1998	9,329,632,470	9,287,455,949
FY 1999	9,826,031,240	9,770,861,657
FY 2000	10,218,505,894	10,194,205,431
FY 2001	10,826,200,846	10,803,573,538
FY 2002	11,219,066,209	11,200,348,474
FY 2003	11,378,339,339	11,298,184,668
FY 2004	11,452,126,533	11,433,774,956
FY 2005	12,219,576,317	12,176,760,241
FY 2006	13,620,939,234	135,857,869,906

<sup>1</sup> Beginning of fiscal year appropriations for General Fund-State.

<sup>2</sup> Does not reflect debt service, which can legally exceed the appropriation.

<sup>3</sup> Does not reflect all retirement contributions, which can legally exceed the appropriation.

<sup>4</sup> Includes \$4.7 million in allotment reductions exempted from the Savings Incentive Program by the Legislature in the 2002 Supplemental budget.

<sup>5</sup> Total reversions of \$80.2 million includes \$43.9 million in allotment reductions exempted from the Savings Incentive Program in the 2002 and 2003 Supplemental budgets. \$36.2 million reflects the non-exempted reversions.

<sup>6</sup> Total actuals include \$1,566,019 spent on fire mobilization efforts that is not counted in the reversion calculation.

This spending is covered by fund balance rather than within existing appropriations.

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<sup>15</sup> State of Washington Office of Financial Management, p. 5.

Table 4. Washington State Savings Incentive Program Distribution<sup>16</sup>

## Summary of Washington State Savings Incentive Program Distribution

### State Savings Incentive Program- RCW 43.79.460

	FY 1997	FY 1998	FY 1999	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	Total to Date
Total Savings Incentive allocation to agencies	\$7,195,113	\$3,818,384	\$4,855,871	\$2,202,916	\$4,055,657	\$2,501,261	\$6,079,956	\$3,737,324	\$5,298,493	\$4,990,884	\$44,735,857*
Transfers to Education Savings Account for School Technology and Construction	51,737,034	34,522,323	45,282,341	20,826,676	17,299,625	10,366,155	27,135,046	13,152,828	33,765,825	28,554,641	\$282,642,494
Transfers to Higher Education (see detail below)	2,797,893	3,835,814	5,031,371	2,314,075	1,922,181	1,151,795	3,015,005	1,461,425	3,751,758	3,172,738	\$28,454,055
Total Education Savings Account	\$54,534,927	\$38,358,137	\$50,313,712	\$23,140,752	\$19,221,806	\$11,517,950	\$30,150,051	\$14,614,253	\$37,517,584	\$31,727,379	\$311,096,549
Total Revisions	\$61,730,040	\$42,176,521	\$55,169,583	\$25,343,667	\$23,277,462	\$14,019,211	\$36,230,006	\$18,351,577	\$42,816,076	\$36,718,262	\$355,832,406
50% to Distinguished Professorships	1,398,947	1,917,907	2,515,686	1,157,038	961,090	575,898	1,507,503	730,713	1,875,879	1,586,369	\$14,227,028
17% to Graduate Fellowships	475,642	652,088	855,333	393,393	326,771	195,805	512,551	248,442	637,799	539,365	\$4,837,189
33% to the CTCs for faculty awards	923,305	1,265,819	1,660,352	763,645	634,320	380,092	994,952	482,270	1,238,080	1,047,004	9,389,838
	<b>2,797,894</b>	<b>3,835,814</b>	<b>5,031,371</b>	<b>2,314,076</b>	<b>1,922,181</b>	<b>1,151,795</b>	<b>3,015,006</b>	<b>1,461,425</b>	<b>3,751,758</b>	<b>3,172,738</b>	<b>\$28,454,055</b>

<sup>16</sup> State of Washington Office of Financial Management, p. 8.

## **H. DISCUSSION OF INTERVIEW RESULTS**

As part of this research project, structured interviews were conducted with careerists in of DoD financial management and contracting communities. Twenty interviews were conducted using the same set of questions (see appendix A). As noted, interviewees were guaranteed anonymity so no citation of their comments is provided. The overwhelming majority of interview subjects (95%) agreed that there is a problem with year-end spending. But they also believe that the problems are fixable. Subjects had been employed from two to fifty years in the fields of financial management, contracting, and command positions. A number had filled several roles and a wide variety of experience was represented. Agency levels ranged from field agency to service departments, with budgets from \$200 thousand to over \$20 billion. Subjects were selected from field operations and the Naval Postgraduate School's faculty and student body. All had extensive familiarity with year-end spending and valuable insights.

The clear consensus of higher-level officials was in favor of instituting a carryover incentive, while those at lower levels were split. One general officer estimated that his service loses over \$400 million every year in budget authority. He claimed that if this appropriation was available to him in the upcoming year, it would make a huge difference to the service as a whole. High-level managers see the total amount of money that falls out every year, whereas field agency personnel see only their own budgets. That high-level managers are in a better position to comprehend the ramifications of unfunded requirements may explain their greater support for carryover capability.

The majority of those interviewed believed that there are problems with year-end spending. Some blamed Congress; others indicated it was a tactical problem at the field-agency level. When asked how much of the last two months of year-end spending goes to low-priority or partly wasted funds on average, respondents estimated that 24% goes to low priority and 8% is at least partial wasted. One subject's opinion as to why this may happen and why it is sometimes unavoidable was stated as follows, "As it is now, requirements are funded as they pop up allowing for some of the lesser priority items to be funded."



Subjects were asked when organizations start year-end-spending preparation. Some respondents claimed they started at the beginning of the fiscal year, while others started as late as August or September. The majority stated that their organization started between May and late July. Preparation included planning purchases, withholding funding for supplies and travel, and racking and stacking priorities lists. The question was asked whether there was enough time to properly execute their agency's O&M budget. Forty percent of subjects felt there was not enough time. One explained his reasoning: "Often there is no budget, no continuing resolution, a late releases of funds, delayed starting, 10% constraints in the last two months of the year and then huge amounts of money fall at the last second."

When subjects were asked how to fix the problem of year-end spending, three actions were repeatedly suggested. First, give more flexibility and time to lower-level agencies so they can make better decisions. Second, give agents incentive to generate savings and spend wisely. Third, agencies should plan ahead and prepare for the end of the fiscal year better.

Subjects were asked if they thought a carryover incentive would improve savings and decision making. Eighty-five percent believed it would. Those who favored the idea believed it would allow more time for contracting and strategizing, while removing the fear of loss. Those opposed to the idea believed it would only move year-end spending problems to a future date. "I believe that would just encourage 'more of the same'... if it hasn't been spent by that time (year-end), it doesn't appear to be needed i.e. the necessary expense and bona-fide need rules)."

When asked about long-term impact, most subjects had favorable views. "We would buy things as they are needed, rather than splurge all at once, which typically happens in early fourth quarter." Another subject responded, "It would stop the panic spending and allow organizations to continue ops and not slow down to deal with closeout and the restrictions that go along with it". Only 15% indicated that a carryover incentive would have a negative impact. The main reason given was that it would only compound year-end spending problems and possibly lead to cuts to budget baselines.

Subjects were asked for examples of how the current one-year-obligation system has influenced their mission for better or worse. Two common responses mentioned training requirements that crossed over the fiscal year but did not have guaranteed funding. Another response cited less-than-strategic use of flying hours at end of fiscal year. “We tend to fly extra flight hours in the last month, perhaps without ensuring the best use of those hours.” One observation focused on civil engineering, “Civil engineering usually has plenty of projects on the shelf that could use funding; they are the ones who will stay until midnight trying to get as many of them funded as possible, even if they are not mission-critical. Having a carryover incentive would give them more time to prioritize what is important.”

Regardless of how a subject felt about carryover incentives per se, much skepticism was expressed regarding the feasibility of actually enacting such a program, especially given the track record of budget-and-execution rule changes. Subjects almost uniformly agreed that Congress would never pass a carryover incentive because it would limit their oversight or discretion in some way. Some expressed the opinion that if Congress did allow carryover incentives, it would not necessarily be a good thing for the DoD. “I don’t think Congress would want us to pocket some funds to spend in the next FY, partially for control reasons. If it actually happens, I think Congress would look at the top-line unobligated funds and either decide that the services didn’t really need the funds to begin with and cut them, or reduce new FY funding by the amount of the carryover funds each FY when the new PB (President’s budget) is submitted. Either way, services would lose. ”Nevertheless, most of those interviewed (75%) did favor a carryover incentive despite their anticipation that Congress would not approve the proposal.

This chapter has outlined the carryover incentive program proposed in this project. The proposed plan is based on the successful implementation of carryover incentives in Washington State, Oklahoma State and the Justice Department. A detailed analysis of each of these implementations has shown that the carryover incentive is a viable option and one that is already producing beneficial results. Additionally, a summary of interviews conducted with DoD budget and contracting personnel has shown

that although there is some reservation to change, many in the DoD would like to have a carryover incentive. Having shown the potential for the carryover incentive, the case must still be made for the need to change. The next chapter presents the reasons for change but also the urgency.

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## **V. REASONS FOR CHANGE**

### **A. AN IMPENDING BUDGETARY CRISIS**

Aaron Wildavsky points out that while the current system is not perfect, even in its imperfection it provides the basics of what he refers to as the “seasons” of budgeting. “Budgeting is supposed to contribute to continuity (for planning), to change (for policy evaluation), to flexibility (for the economy), and to provide rigidity (for limiting spending)” (1973, p. 501). Even so, the nation faces a budgetary crisis. Entitlements alone account for roughly 70% of annual federal spending and discretionary spending dwindles every year as a percentage of the national budget. The Office of Management and Budget estimates that in 2017 the US will begin paying more out in Social Security and Medicare than is brought in annually. This could lead to cuts in social security and other entitlements. The national debt is nine trillion dollars and growing, in part due to continuing annual deficits and also due to interest on the debt.<sup>17</sup> Social Security and Medicare costs will continue to swell as the baby-boomers retire and healthcare costs rise. At the same time, the global war on terrorism has staggered the infrastructure of the military, which must be recapitalized to keep effective. Recapitalization is very expensive, and according to the Major General Frank Faykes, Deputy Assistant Secretary for Budget, Office of the Assistant Secretary of the Air Force for Financial Management and Comptroller, will come at the cost of operations and maintenance funds (Faykes,2007).

The style of budgeting researched here is considered an entrepreneurial approach. Dan Cothan’s “Entrepreneurial Budgeting: an Emerging Reform?” cites cases at the local level and several in foreign governments, e.g., Canada, New Zealand, and Australia, that have implemented the ideal of delegation of authority to lower agencies (1993). This trend is consistent with management control theory<sup>18</sup>—note that, in the private sector, the

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<sup>17</sup>The Hill online newspaper, retrieved 20 November from <http://thehill.com/leading-the-news/wincing-dems-are-likely-to-raise-the-limit-on-debt-2007-03-12.html>.

<sup>18</sup> Based on previous discussion and contents in Merchant p.181.

management theory mantra is that “unless you reward people as entrepreneurs, they become technocrats” (Merchant, 2003, p. 539).

## **B. CONGRESSIONAL HEARINGS ON UNOBLIGATED BALANCES**

Although Congress is assumed the biggest obstacle to reform, convincing Congress is by no means unthinkable. Congress has held hearings on granting greater flexibility over unobligated funds and tested the concept in the Department of Justice (albeit in a different form from the proposal researched here). On May 18, 2006, top budget officials from five major federal departments—defense, justice, health and human services, transportation, and veterans affairs—were brought before the Homeland Security and Government Affairs Subcommittee on Federal Financial Management, Government Information, and International Security. Chairman Tom Coburn, R-Oklahoma, asked the extent to which agencies carry large balances of unspent funds and how those funds affect their operations and annual budget and appropriations processes and sharply questioned whether unobligated funds could be better used (Conlon, 2006),.

A unique authority granted to the Justice Department by the 1992 Commerce–Justice-State appropriations law (PL 102-104) allows Justice to transfer certain expired balances to a special “no year” unobligated-balance transfer account within the department’s working-capital fund instead of returning it to the treasury. At the 2006 senatorial hearing, agency representative Lee L. Loftus asserted that this arrangement enabled Justice to use large numbers of small, unobligated balances for major departmental expenditures. Impressed with Mr. Loftus’ data, Senator Colburn floated the proposition of giving other departments the same authority, to reduce future budget requests. Loftus confirmed that in his experience “the greatest advantage in the authority is that it allows us to maximize the use of the appropriations we receive and diminishes the need for us to ask for new money.” (Conlon, 2006, p. 1)

## **C. THE IMPACT ON WAR FIGHTING**

Perhaps the greatest imperative for reform is the need to gain new flexibility on the battlefield. As enemies adapt and innovate, so must our forces, especially in an

asymmetrical paradigm. The mine-resistant, ambush-protected (MRAP) fighting vehicle is one example of the need for swift adaptability. Since the beginning of the conflicts in Iraq and Afghanistan, over 27,700 American servicemen have been killed or wounded,<sup>19</sup> and of this number, approximately 70% of casualties occurred in vehicles. The vehicle used in the majority of GWOT operations is the HMMWV (Hummer). This vehicle was not designed to withstand blast from improvised explosive devices (IEDs) or rocket-propelled grenades (RPGs). Capitalizing on this vulnerability, the enemy has targeted vehicles, with high success. The Marine Corps is seeking a vehicle designed to withstand IEDs and RPGs. As troops are wounded and killed, acquiring MRAPs has been elevated to top priority by Secretary of Defense Robert Gates. Secretary Gates went on to question what was holding up the process of acquiring these vehicles. “In this regard, I would like to know what funding, material, program, legal or other limits currently constrains the program and the options available to overcome them.” (Defense update, 2007, p.1)

The pressure to field this vehicle casts a dismal spotlight on the shortcomings of the budget-and-acquisition process. Although all agree that MRAPs must be built, the DoD must go account-raiding to pay for them. Agency incursion into others’ purses generates universal resistance and protectionism, which must be sorted out politically, wasting precious time. If in this scenario the DoD had access to carryovers held in an unobligated, expired-funds account (O&M or procurement-expired funds), the search for funds would be unnecessary and procurement of MRAPs greatly accelerated. In this case, as in many DoD and disaster cases, delay and complication translate baldly to lives lost. While Congress has valid reasons to place restrictions on all federal agencies, including the DoD, it must be recognized that these strictures may hamstring the DoD’s ability to fight wars. That Congress might simultaneously exercise both its duties in defense and budgeting—that is, might keep due control while at the same time encouraging innovation and agility—is emerging as a realistic option.

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<sup>19</sup> Iraq Coalition Casualties Count website, retrieved on 30, September 2007 from [www.icasualties.org](http://www.icasualties.org).

#### **D. RESISTANCE TO CHANGE**

In his article “A Budget for All Seasons” (1978), Aaron Wildavsky claimed that “bureaucratic inertia,” the damping force of legal, structural, and cultural processes, makes any reform likely to be smothered by the system. Change is therefore attempted only when a problem is so great it has to be addressed. Unfortunately, forced change usually results in piling on of restrictions, leaving government ever more cumbersome and inflexible. Historically, Congress has not fixed problems by granting greater freedom of judgment; it fixes them by adding bureaucracy and revoking discretion. Arguments for greater discretion at the agency level would have to be either overwhelmingly powerful or bolstered by a groundswell of popular support to succeed. We may be at such a point now. With projected federal expenditures going up and revenue going down, reforms will have to be made. Whether the changes entail a decrease in expenses depends on how convincing is the case for cutting expenditures: Cutting expenditures, or improving the efficiency with which they are spent, through savings is by far the more attractive solution to agents.

Pinning down what actually happens to savings at the end of the fiscal year is elusive, because the present control systems do an excellent job of ensuring that every penny is spent. Fred Thompson of Willamette University observed, “One reason for this [lack of empirical evidence] is that there is not much variation in budget practices in government... One cannot explain any variance if there is no variance to explain” (Jones, 2005, p. 144). There are very few cases of savings to study. Even if an organization does save money at end of year, they are not likely to say so because they may be punished for it. Steve Kelman of Harvard University observed, “It leads to a situation where the savings don’t get generated in the first place” (Jones, 2005, p. 139).

#### **E. THE ARGUMENT AGAINST CHANGE**

Defenders of the present system argue that it contains enough benefit that there is no compelling reason for reform (Wildavsky, 1978). Not only does it satisfy basic requirements, but funds are not technically wasted in the rush to spend anyway: the law mandates that these funds be used only on legitimate requirements, and even in the worst



cases, waste at least recycles through the economy. Many congressmen consider the percolation of funds a tremendous benefit, especially to their home districts. This perspective has dampened enthusiasm for reform.

## **F. THE ARGUMENT AGAINST CARRYOVERS**

There are three significant arguments against extending the obligation period through carryovers. First, critics regard the incentive plan as a way of lengthening the budgeting period. It must be underscored, however, that under this proposal, Congress would still budget annually—the role of Congress as overseer is understood and protected. Second, as Wildavsky argues, the system appears to work well enough (1973). It may be observed in response that while complacency may be the reason a system goes un-reformed, such an attitude regarding vital systems is never warranted. The vexatious prospect of additional work does not obviate Congress's duty to execute its primary constitutional responsibilities as competently as it can, or dictate that a haphazard legacy of inefficiency must endure forever. Finally, critics ask why it should be necessary to lengthen the obligation window when Congress has every intention of supplying each year's needs. The simple answer is that unpredictable and one-time needs pop up and ruin even the most carefully projected budget, leaving the mission vulnerable to compromise. A budget that is allowed to play out in a stable, orderly fashion, despite the predictable unforeseen, is of significant benefit. However, seldom is the DOD budget executed under predictable and stable conditions.

This chapter has presented the reasons and the urgency for change as well as the obstacles and reasons for not changing the federal budget process. There are critics on both sides of the issue, but what can be agreed upon is that DoD budgeting must meet the need of the war fighter in the years to come. A proactive approach to addressing those needs will prevent lapses of national defense and wasted resources.

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## **VI. CONCLUSIONS AND RECOMMENDATION**

### **A. SUMMARY AND CONCLUSIONS**

This research traced incremental budgeting to its origins and shown an evolution marked by reaction rather than careful and prescient design. The system has served for over 200 years, but never to high satisfaction, and is roundly condemned for inviting chaotic yearly spending sprees and pork-barrel appropriations.

This project examined whether year-end rushes to spend are a reality and a problem. Rushes were affirmed as real and problematic. Agency theory was invoked and its use suggested that if principals can align agents' goals with their own, both sides of the transaction will benefit; conversely, if their goals conflict, agencies will protect themselves at the principal's expense. This relationship is assumed to be a valid description of Congress and the federal agencies, and a principal-frustrating dynamic may be assumed in play during the yearly spree.

This project considered whether a proposed carryover incentive would improve the system. In case studies of the states of Washington and Oklahoma, agencies offered a carryover incentive favored the policy overwhelmingly. Testimony before Congress confirms that a number of federal agencies also support carryover incentives. The Justice Department has reported substantial savings and improved efficiencies under such a regime. Interviews with senior executives highly experienced in year-end closeouts indicated support for the idea of carryover incentives as well.

Risks associated with carryover incentives include agency manipulation for Congress and potential funding cuts to agencies. Projected benefits, however, were found to justify the risks. The author notes that in his research, successful implementations of a carryover system were found, but no case of failure was discovered. Follow-on research may identify failures as they are revealed in time. Degree of success has depended on the organization, but no organization reported being hurt by the experiment. In Oklahoma

State's, Washington State's and the Justice Department's experience, substantial savings were generated and mission achievement improved.

While a significant downside risk was not found in this research, gains in savings and mission accomplishment surfaced quickly. Potential savings were found in diverse forms, including the better employment of end-of-year man-hours, more advantageously crafted contracts, improved expenditures in lieu of rushed decisions, and—intangible but very powerful—changes wrought in agency culture when executives and staff are allowed to think and act like entrepreneurs and are rewarded for exerting this power on behalf of the nation.

Because this research concerns an emerging and mostly experimental development, the degree of rigor and scope in data collection and analysis sought by the author was not possible to obtain. Follow-on work is expected to display finer precision as better and more data emerges.

## **B. RECOMMENDATION**

Congress, through the leadership of Senator Coburn's subcommittee on Financial Management, Government Information, and International Security should propose legislation to authorize a trial carryover incentive for a small number of DoD agencies for up to five years. Senator Coburn's committee is already versed with the problems inherent in the budget and execution process. This five year period will allow the agencies to define their baseline budgets and learn to utilize carryovers to best meet mission needs. These chosen agencies should be diverse in size, mission, service, and annual budget authority. Congress should appoint the DoD comptroller, military departments and service comptrollers to implement and evaluate the program. Congress also should require annual reports on the use of carry over incentives and review results in the form of hearings and reports annually. These reports should describe how the carry over appropriations are used, savings generated, and overall mission impact resulting from the program.

Congress should also authorize a broad spectrum and well publicized study of the potential for the implementation of a carryover incentive. This study should be carried

out by the Government Accountability Office. The study should incorporate the opinions of federal financial managers and contracting personnel. The goal of the study should be to determine mission impact, cost savings, and expected utilization of the carryover incentive by agencies. Broad knowledge of the study and including financial managers at all levels will help to remove some of the pessimisms about budgetary changes and generate greater buy in at lower levels should the carryover incentive plan be adopted into law.

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## APPENDIX. MBA RESEARCH PROJECT QUESTIONS

This survey is part of Naval Postgraduate student MBA research project on the efficiency of year-end spending and the potential benefits of offering carryover incentives to organization that do not fully execute their budgets by the end of the fiscal year. The anonymity of respondents will be protected.

1. What position(s) have you held while involved in year-end closeout?  
Commanding Officer, Comptroller, Budget Officer, Contracting officer, Accounting,  
Other \_\_\_\_\_ (Circle one)
2. How many year-end close-outs have you been involved with? \_\_\_\_\_
3. At what level of activity did you participate in end-of-year close-out? (Unit, Squadron,  
Wing, Base, MAJCOM, Service, DoD) \_\_\_\_\_
4. Approximately how much O&M budgetary authority does your organization execute  
annually? \_\_\_\_\_
5. On average what percentage of total annual O&M funding (TOA) does your  
organization obligate annually? \_\_\_\_\_%
6. In your opinion do you think there is a significant problem with year-end spending and  
closeout procedures in the Federal Government? Yes, No
7. If you think there are significant problems with current closeout procedures do you  
think they can be fixed? Yes, No
8. If you think they can be fixed, do you have recommendation for how they could be  
fixed?  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
9. If you think they can not be fixed, why not?  
\_\_\_\_\_  
\_\_\_\_\_
10. On what date are spending restrictions imposed on your organization and what date  
do you restrict spending for your subordinate units? Your unit \_\_\_\_\_  
Subordinates \_\_\_\_\_

11. In your opinion, do you feel there is enough time in the current O&M obligation period to maximize the use of your financial resources?

12. In your opinion, what percentage, if any, of year-end obligations falls into the categories of low priority or at least partially wasted spending.

Low Priority\_\_\_\_\_ Partially Wasted\_\_\_\_\_

13. In your opinion, in order to manage a successful year end what month does an organization need to start planning for year-end purchases? \_\_\_\_\_

14. What technique would you recommend to measure the propriety and efficiency of year end spending?

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15. Are you familiar with the idea of carrying over unobligated authority into the next fiscal year as an incentive for organization to save funds and improve decision making?  
Yes, No

16. Do you think allowing organization to carryover unexecuted authority would improve savings and decision making?

If yes, why?\_\_\_\_\_

If not, why not? \_\_\_\_\_

17. What impact would allowing unobligated authority to be carried over into the next fiscal year have on your organization and your ability to execute O&M funds?

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18. Do you have examples that either support maintaining the current year-end obligation constraint or support allowing a carryover incentive?

Comments\_\_\_\_\_

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19. Do you have any additional comments about the one year obligation period, year-end close out procedures, or allowing carry over incentives?

Comments\_\_\_\_\_

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